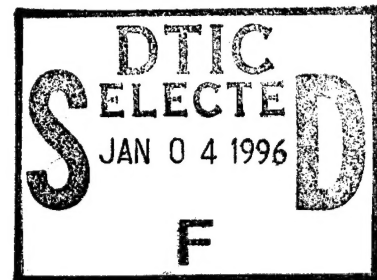


# NAVAL POSTGRADUATE SCHOOL

## Monterey, California



## THESIS

**THE IMPACT OF INFLATION ON FAMILY MONEY INCOME  
DISTRIBUTION IN VENEZUELA DURING THE 1980s**

by

Luis Manrique

June 1995

Thesis Advisors:

Katsuaki L. Terasawa  
David R. Henderson

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DISTRIBUTION IN VENEZUELA DURING THE 1980s**

Luis Manrique  
Lieutenant Commander, Venezuelan Navy  
BS, Naval Academy of Venezuela, 1980

Submitted in partial fulfillment of the  
requirements for the degree of

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**June 1995**

Author:

Luis Manrique

Approved by:

Katsuaki L. Terasawa, Principal Advisor

David R. Henderson, Associate Advisor

David Whipple, Chairman

Department of Systems Management

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## **ABSTRACT**

This thesis addresses the effects of government regulated inflationary controls and measures on family income distributions in Venezuela during the 1980s.

The Venezuelan government has instituted many methods of economic intervention during the last decade through exchange rate controls, price controls, tariffs, subsidies, etc., which have had real effects on family income distribution. The effects of these policies on unemployment, nominal wages and salaries, and price variabilities are researched and recommendations are presented. An overview of the current Venezuelan economic condition, beset with problems of past inflationary controls and measures, is assessed and presented. The Venezuelan economy, mainly supported by oil revenues, has potential for a more equitable distribution of family income, given properly controlled fiscal policy and the willingness of the government to decrease anti-competitive economic laws.



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## **I. INTRODUCTION**

### **A. BACKGROUND**

A change in intellectual approach has been primarily responsible for a growing concern with problems of economic inequality during the present century. Universally, society no longer accepts inequality as an immutable condition of people, and wide differences in standards of living are no longer held to be inevitable.

The extension of social security schemes to cover all classes of the population is both a consequence of this new intellectual approach and a reflection of the much greater possibilities that now exist for maintaining the real incomes of every member of society above a certain minimum (Lecaillon, 1984, p. 1).

An economic policy aiming to provide a minimum standard of living requires the collection of information needed for its formulation and the monitoring of progress made in its application. At the same time, flow of statistics and reports on poverty and economic inequality have had the effect of focusing public attention on those issues, thereby fostering a change in the intellectual approach to them.

The concern with inequality in industrialized countries is paralleled in developing countries, where it is intensified by more acute poverty and a more urgent call for action. A parallel has likewise developed between the concern over inequalities within countries and the concern over inequalities between countries.

At first, research was focused mainly on the relationship between income distribution and employment. Attention has subsequently shifted to the elimination of poverty, the role of fiscal policy, and public services.

Income redistribution comes in all kinds of packages. Although there is a large number of people agreeing that the government should play some role in income redistribution, there is also a great deal of argument over how much public subsidy should be available (Eggert, 1983, p. 67).

## **B. OBJECTIVES**

The subject of this thesis is the impact of inflation on family income distribution in Venezuela during the eighties. The objective is to examine the interplay between the economy and political forces in Venezuela in an effort to control inflation as experienced in the 1980s. Of particular interest are the circumstances leading to the economic policies resulting in the decline of real per capita income for all income groups in the last decade.

This illustrates a consistent tendency for political forces to favor wage and price controls and attendant subsidies over more effective market-oriented policies despite higher short-term social costs.

## **C. ORGANIZATION**

The following chapters will present the evolution of the inflationary process in Venezuela and its effect on family income distribution. The thesis will be split into four chapters. The first chapter presents some basic ideas for understanding the causes of inflation and the evolution of the inflationary processes in Venezuela. The second chapter has a summary of statistical evidence on the effect of inflation on wages and price variability. The third chapter describes the influence of inflation on family income distribution. The fourth and final chapter offers some conclusions concerning the effect of inflation on family income distribution in Venezuela, and the dilemmas of anti-inflationary policy used to reduce the impact of inflation on society.

## **II. EVOLUTION OF INFLATION IN VENEZUELA**

### **A. INTRODUCTION**

The objective of this chapter is to explore the evolution of inflationary processes in Venezuela and to provide some general information on its causes.

The problems associated with inflation are many; they have their impact in all the sectors of the economy and are part of the changing economic environment.

Inflation is not a phenomenon resulting from a single cause, but a process that emerges in a chain of complex circumstances which supersedes simple cause-and-effect (Indacochea, 1992, p. 42).

Inflation is presented in monetary activity. It often has the undesirable effect of grossly distorting income distribution. The victims include savers, lenders, and people with fixed incomes; while these groups lose, others (including borrowers and speculators) win.

At its best, mild inflation is merely irritating, if it is accompanied by full employment. At its worst, however, inflation invites panic buying and can lead to the eventual collapse of a monetary system (Eggert, 1984, p. 13).

Inflation is a common term. Frequently, it is said that inflation exists simply because prices are high. This, by itself, does not constitute a test for inflation.

Inflation can be defined as a general increase in the level of the prices of the goods and services of an economy.

In the process, the monetary units lose purchasing power.

When newspapers tell us "inflation is rising" they are really reporting the movement of a price index. A price index is a weighted average of the prices of a number of goods and services. In constructing price indexes, economists weigh individual prices by the economic importance of each good. The most important price indexes are the consumer price index, the GNP deflator, and the producer price index (Samuelson, 1994, p. 589).

The most widely used measure of inflation is the consumer price index, also known as the CPI. The CPI measures the cost of a market basket of consumer goods and services.

The concrete causes of inflation are varied, but basically, inflation is produced when the monetary supply grows larger than the supply of goods and services (Toro, 1993, p. 463). In other words, inflation is an excessive increase in the amount of money in circulation.

Inflation is not due to speculators, neither to bankers, nor to a conspiracy of powerful groups.

Inflation is substantially a monetary phenomenon, and it is associated with the conduct of the authority that issues money: the government (Marquez, 1991, p. 921).

Inflation has two specific effects, which at the same time tend to produce an increase in the money supply. These effects are distortions in the relative prices and output of different goods (or sometimes in output and employment for the economy as a whole) and a redistribution of income and wealth among different classes (Samuelson, 1994, p. 594).

The major redistribution impact of inflation occurs through its effect on people's wealth, which takes the form of a decrease in the value of the money. Because of this, those members of the society who receive a fixed income in nominal terms are affected negatively, as well as those whose income grows at a pace less than the rate of price increases.

Other effects are the distortion of the exchange rate, the distortion of interest rates, and increases in the fiscal deficit.

As a rule, it can be said that inflation hurts or benefits the members of the society in a random manner and produces an inequitable income distribution (Toro, 1993, p. 490).

In countries that suffer from rapid inflation, an increase in social conflict is observed, as well as the perception that work has lost much of its value. This reinforces the general sense of social injustice. Therefore, since nobody wants to lose due to

increases in prices, they demand increases in salaries and wages, and are prepared to strike in order to achieve what they believe is necessary.

In the initial stages of inflation, some governments try, for months or even years, to maintain the exchange parities. If the exchange rate remains the same and inflation persists without control, then currency becomes overvalued. This increases the pressure on imports hurting exports, stimulates the flight of capital, and international reserves fall quickly.

In this situation, in spite of the fact that the devaluation already seems unavoidable, governments may still continue to impose exchange controls to maintain the parities. When they must finally adjust the currency, the adjustment must be greater. This has been the case in Peru, Ecuador and Venezuela (Marquez, 1991, p. 21).

## **B. INFLATION IN VENEZUELA**

In 1936, Keynes published his "General Theory of Employment, Interest, and Money. Keynes said that the governments are responsible for amending the imbalances in the insufficiencies of aggregate demand, with the application of expansive fiscal policies through an increase in governmental expenditures.

Venezuela began to apply the theory of Keynes during the government of General Lopez Contreras (1936 to 1940) through government expenditure, financed by income originating from oil.

Venezuela reacted well to Keynes' economic model, as can be seen in the growth of the GNP (Figure 1). This model was easy to apply, since the Venezuelan government had only to spend money received from the oil on health, education, public works, subsidies, and so forth. Also, the government stimulated the private industrial, agricultural, commercial, and service sectors by giving them financial credits and protection to grow and develop.



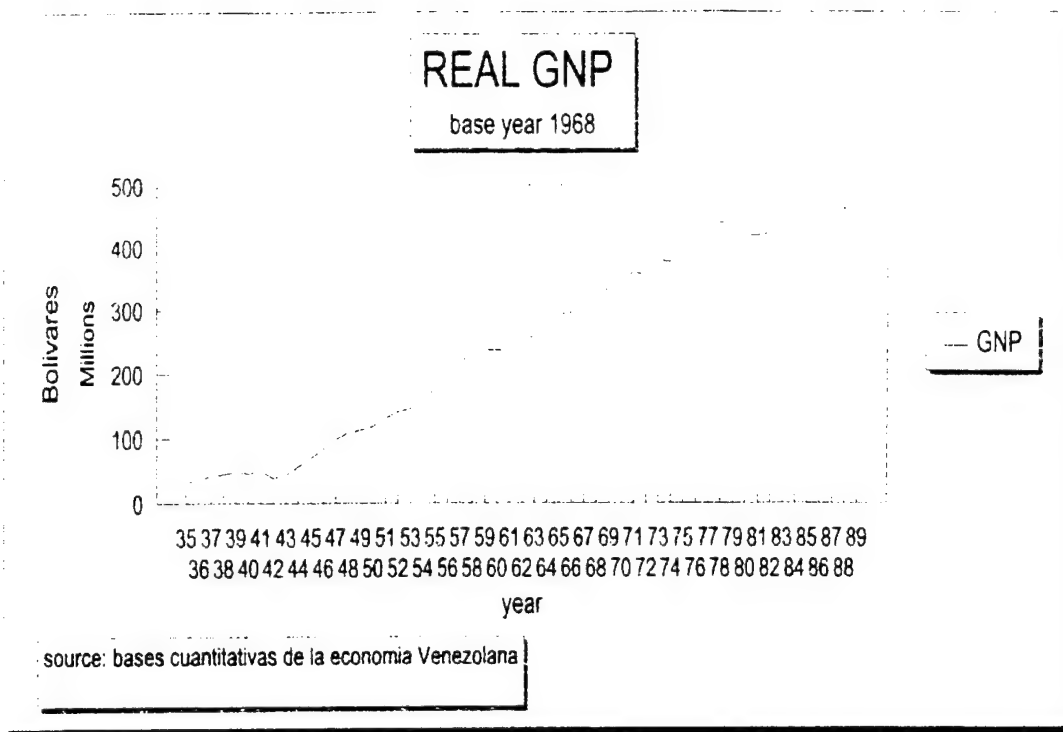


Figure 1. Venezuelan GNP, Base Year 1968.

Venezuelan economic activity depends in great measure on the national budget or the expenses of the public administration. For that reason, a bureaucratic system to distribute money originating from oil profits was created to stimulate aggregate demand.

Since the 1950s, the Venezuelan economy has had an increasing and stable pace of growth, with one of the lowest inflation rates in the world and real positive interest rates. The exchange rate in relationship to the dollar remained fixed.

The interest rates stayed undisturbed for long periods, the income originating from the oil industry was growing, and the government was operating without incurring a deficit with a very conservative monetary policy.

Due to increases in the prices of oil in late 1973, resulting from the Arab oil embargo, the Venezuelan government widened its fiscal resources and external surpluses. These were used to promote the development of the country and to create a productive system that would assure the future.

### C. 1974 TO 1978

In March of 1974, the first term of government of President Carlos Andrés Pérez began. Economic decisions were made to maintain the fixed exchange rate (Figure 2), and increase government expenditures.

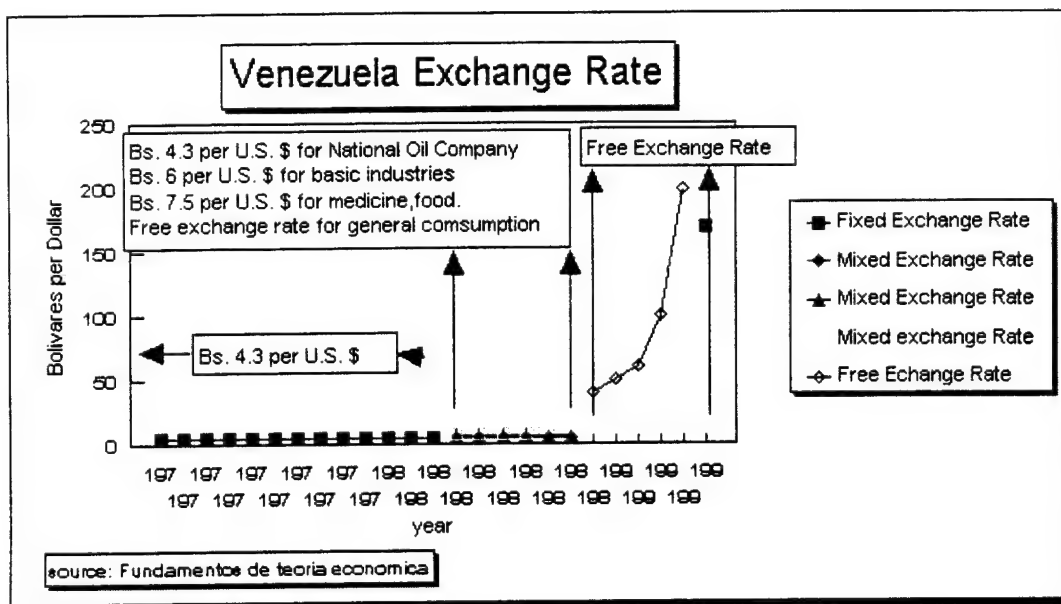


Figure 2. Venezuelan Exchange Rate, 1970-1993.

The analysis of this period starts by establishing that the Venezuelan economy, with a fixed exchange rate system, is affected neither in the short run nor in the long run by oil revenue or government expenditure in goods marketed internationally (imported or exported). The only effect is the alteration of the balance of payments and the fiscal deficit.

On the other hand, the government expenditure in those goods that are not marketed internationally had an influence on the revenue, the employment and the wealth of households. For goods marketed internationally, the difference between production and demand is covered through international trade. For goods that are not marketed internationally, the internal production must necessarily be equal to its demand.

The Venezuelan government began development plans, envisioning investments in all types of state enterprises financed with external loans and with the resources originating from the oil that had been deposited abroad through the Investments Fund of Venezuela.

The expansive policy of government expenditure spurred a rapid increase in the productive activity, expressed as an increase in the GNP (see Figure 1).

In 1975, the Venezuelan economy began to experience deep transformations. The rapid increase in the monetary supply which originated from the increase in the prices of oil pressed the growth of the economy. The expansive fiscal policies of the government on the demand side for the first time in many decades produced marked upward pressures on prices.

Inflation increased, reaching an annual rate of 13.5% and marking the beginning of the inflationary process (Figure 3). Inflation in Venezuela has been influenced by a price control system and high subsidies established by the government. These were useful to reduce inflationary tensions, but in the long run created greater problems in the economy by maintaining it artificially.

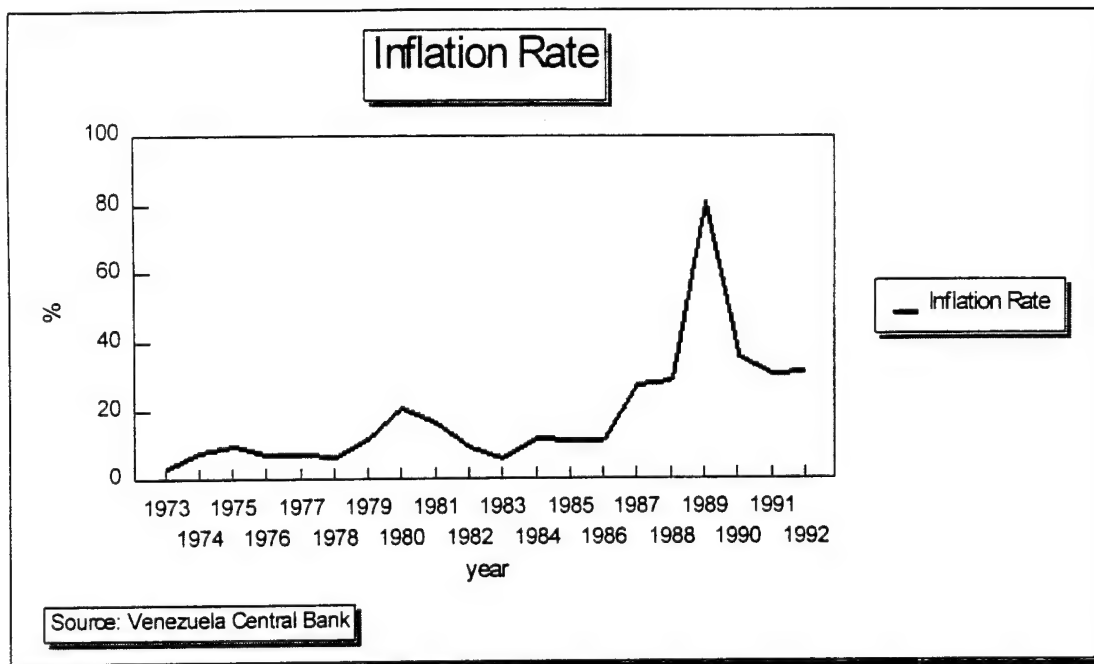


Figure 3. Venezuelan Inflation Rate, 1973-1992.

The years 1975 and 1976 were characterized by growing government expenditures, and by an important decrease in oil revenue. During 1977-1978, supply was surpassing demand in the oil markets and the price of oil decreased, reducing the net revenue of the country. This trend of decreasing external revenue compelled the government to employ a fiscal austerity policy, based mainly on the reduction of central government expenditures in goods not marketed internationally.

The lack of discipline resulting from the financial and operative deficit of a great number of public enterprises and services created during the first general increase in oil prices (1974) began to cause growing capital expenses during the period 1977-1978. Due to the fact that the increases in the prices of oil were not permanent, Venezuela incurred a large external debt and an acute fiscal deficit (Toro, 1993, p. 483).

In order to cover the fiscal deficit, the government appealed to successive devaluations of the national currency. Since the greater part of the fiscal income of

Venezuela is in dollars originating from the exports of oil, devaluation has a very special advantage for the public sector: it transforms the same amount of dollars into a greater number of "Bolivares" (BS).<sup>1</sup> The greater number of BS thus received permits the government to adjust the short term fiscal deficit.

Through the devaluation mechanism, the Venezuelan economic system receives a great quantity of BS that does not find location in the economy, neither does it generate a parallel increase in the production of goods and services. For that reason, the increase in BS or money supply exercises pressure on the general level of prices (Toro, 1993, p. 482).

Strong aggregate demand and imports, in 1978, created a fiscal deficit in the external accounts as well as in the fiscal balance. As a consequence of the increased intervention and investment of the Venezuelan government, the economy experienced structural change. All of this contributed to injure the competitive capacity of the private sector. It became more regulated and controlled by the state and at the same time became more dependent on the state for profits and for survival.

A presidential decree of 1974 established double compensation payments for unjustified employee dismissals together with a general increase in salaries and wages, but this only decreased work productivity.

The increase in oil prices and other raw materials in the international markets was converted into an increase in the international inflation rate. This affected Venezuelan imports and implied an increase in the price of imported goods.

In Venezuela, oil maintained the illusion that the exchange rate was correct for a long time. But in 1978, the pressure of inflation began to erode economic growth and confidence. The Venezuelan government kept its interest rate lower than the international interest rate, and the overvaluation of the BS and the subsequent panic, finally resulted in a huge flight of capital and a necessary adjustment of the exchange rate.

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<sup>1</sup> Venezuelan national currency; US\$1=170 Bolivares

#### **D. FROM 1979 TO 1983**

Upon beginning his presidential period, Luis Herrera Campins was faced with three imbalances: external, fiscal, and employment. Due to the deficit in the bank current account, the government resorted to external indebtedness to maintain its international reserves.

Additionally, it applied a set of measures on the supply side with a restrictive fiscal policy. But, in spite of the efforts of the central government, the expense of the public sector grew, due to the investments of previous years to support the operations of state enterprises.

The recession of 1979-1980, combined with the fiscal and external surplus generated by a second increase in the price of oil due to the fall of the Shah of Iran, caused the government to lose interest in halting the growth of government expenditures. Politically, it was very difficult to justify restrictive fiscal measures at a time when people thought that the increase in the price of oil not only would be of greater duration than during 1973, but also would reach higher levels.

In practice, government import expenditure decreased while internal expenditure and public employment increased. This occurred at a time when the real net oil exports were growing after the revolution in Iran.

During 1981-1982, the government attempted to continue to increase the growth of government expenditure in response to political pressures. It accelerated its spending to stimulate aggregate demand.

This change of direction from a fiscal policy of contraction to expansion was not accompanied with an improvement in the economy. The increase in the quantities of goods and services produced increased inflationary pressures and ended up aggravating the existing economic imbalances in the economy.

Other factors contributed to stress the increase in the level of the prices, among them: the release of price controls maintained by the previous government, the increase in the salaries and wages as of 1980, the high level of interest rates in the national and international financial markets, and finally, imported inflation.

It is important to clarify that in the long run, inflation in the Venezuelan economy with a fixed exchange rate is equal to inflation experienced by the international currency of reference, or US dollars. The differences that occur in the short run reflect adjustments of the real exchange rate, which have an exogenous explanation. Therefore, if a devaluation of the national currency is not made, there will not be the problem of internal price increases beyond those that occur as a result of imported inflation.

The external deficit situation can be generated by a fall in oil revenue or an increase in the payment of the external debt. If the government does not react, a balance of payments crisis will be created. If, on the other hand, the government balances its budget through the cutting of the expense in goods not marketed internationally, initially a recession and a balance payments deficit will be produced. All this supposes that the public is taken by surprise and that it does not anticipate changes in the economic policy.

When the public anticipates a drop in oil revenue and knows that the government prefers a devaluation of the national currency to avoid a recession with the consequent increase in unemployment, the people tend to convert their monetary assets into foreign currencies. This causes a flight of capital that could rush the devaluation. This is in summarized form the situation in Venezuela before of the year 1983, which compelled the government to replace the fixed exchange rate system with a multiple exchange rate system.

In fact, at the beginning of 1982 a strong fall of oil income occurred, more acute than in 1983. This had a negative effect in not only the internal sector, which was showing clear stagnation, but also in the external sector of the economy. This climate of uncertainty and the perception of an imminent devaluation of the national currency sponsored a private flight of capital, reducing the money in the hands of the public and the banks.

The deficit in the balance of payments, together with the flight of capital, caused international reserves to fall. To respond to this situation, in February of 1983 the government eliminated the fixed exchange rate system and substituted a multiple exchange rate (see Figure 2).

The exchange rate control provided for two exchange rates; one with preferential fixed parities (of BS 4.30 and BS 6 for US \$1) and another with variable parities at free market rates (Figure 4).

The price control originally established a freezing of all prices at the domestic level. Then a system of price control was put into action that represented the return to the policy of generalized price control that had been partially abandoned in August of 1979.

With the new price control system, increases in prices were permitted, adjusted to increases in production costs. These increases were influenced by the new costs derived from the devaluation.

The initial result of price control was a reduction in inflationary pressures, obtained simply with a rigid price control and with a large inventory of imported raw materials accumulated in previous years, when they could be imported with a preferential exchange rate.



## Inflation Rate and Money Supply

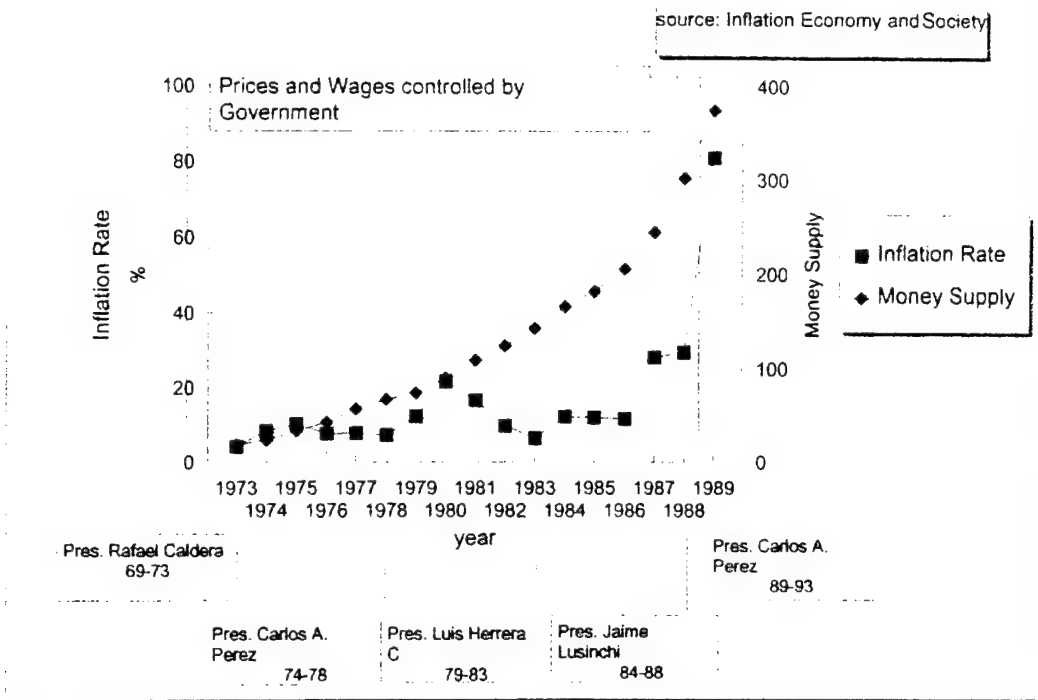


Figure 4. Inflation Rate and Money Supply.

During the decade 1973-1983, due to an increase in oil revenue, the expenses and the indebtedness of the government increased, increasing government expenditures on non-imported goods and causing a deficit in the balance of payments.

### E. FROM 1984 TO 1988

The new president, Jaime Lusinchi, found the country in a critical situation that compelled the government to take a set of restrictive measures. The government modified the preferential exchange rates, reducing the number of transactions being accomplished at a exchange rate of BS 4.30 for US \$1. It limited imports to essentials like food and medicine. It fixed an exchange rate of BS 6 for US \$1 to purchase and to

sell currencies for the oil and iron industry, and created an exchange rate of BS 7.5 for US \$1 for some regulated imported goods and services.

The parallel currencies market made it possible to acquire currencies freely at a floating free market rate for activities that were not considered of high priority.

The fiscal surplus experienced in 1984 was due to greater income originating from the oil sector. But it represented a sacrifice for the population. The level of consumption and the GNP contracted.

The government was convinced that the adjustment stage had already passed, and began to apply a policy to reactivate the economy, but in 1986 the prices of oil began to decrease. To compensate for the fall of oil prices, oil production was increased. Thus, responding to the expansive policies used to stimulate aggregate demand, the GNP grew in real terms and the unemployment rate was reduced.

The government incurred a fiscal deficit and needed to make frequent devaluations of the national currency. The preferential exchange rate was devalued continually until the great devaluation of 1986.

The exchange rate applicable to the greater part of the transactions was increased from BS 7.5 for US \$1, to BS 14.5 for US \$1 while at the same time in the parallel market the devaluation; of the BS was even greater.

In practice, this devaluation was an indirect government tax to obtain a greater amount of BS for each US dollar to cover the fiscal deficit. As consequence of the devaluations the monetary supply was expanded.

The public officials, convinced of the fact that it was necessary to stimulate economic activity, decided to freeze interest rates in 1985. This resulted in an even greater increase in the monetary supply because the interest rate was unfavorable and the public opted for increasing credit. Much of this credit was used to acquire imported goods and foreign currencies, provoking a flight of capital and pressure on the exchange rates in the parallel market. Around the end of 1988, the exchange rate reached BS 39.3 for US \$1.

The administration adopted a set of measures intended to compensate for the deterioration of real income of workers and to contribute to stimulating the aggregate consumption demand through an expansion of the available nominal income. For this reason, in 1986 and 1987, the government decreed an increase in salaries and wages of 10% to 20% for public workers and workers that did not have collective contracts. In 1988, there were no increases in salaries, except those wages derived from collective contracts.

It became more evident that the increase in salaries by means of decrees was leading to a more than proportional increase in prices.

The severe price controls (see Figure 4) led to delays in the approval of requests for price increases. These price increases were necessary to offset the increase in production costs generated as a consequence of the devaluation of the currency.

“To control inflationary pressures”, the prices of the basic market basket were strictly controlled and the producers were given increasing subsidies. In spite of this, by the mid-eighties, the pace of inflation accelerated, and the prices began to grow, especially in 1987 (Toro, 1990, p. 134). In that year, inflation soared to the point where the increase in consumer prices over 12 months reached more than 40%, an unprecedented figure (United Nations, 1987, p. 655).

The acceleration of inflation was primarily due to the devaluation of December 1986, the effect of which spread rapidly and generally. This increased the public sector surplus as expressed in local currency, allowing for an expansion of government spending which strongly exacerbated inflation (United Nations, 1987, p. 655). The impact was strengthened by an initially expansive wage policy, at least with respect to the minimum wage.

## **F. FROM 1989 TO 1993**

President Carlos Andrés Pérez, upon taking office for the second time, faced an inflation rate that approached 30%. However, this index did not reflect reality, since the economy was still operating under a strict system of price controls, subsidies, and

exchange rate controls. This situation could not continue, since the state did not have the necessary resources and the private companies could not operate under the regimen of price controls.

The economic model employed until 1988, based on government expenditure, had been exhausted. The situation in the country was extremely delicate, and required an economic policy with the support of the political parties and the population to achieve economic balance.

A market economy policy and the opening of competition with external markets was chosen. To achieve that objective, however, it was necessary to make a series of macroeconomic adjustments to amend the fiscal deficit as well as the imbalance in the balance of payments.

The results of these policies were observed in a reduction of the fiscal deficit, and also a reduction in the deficit of the balance of payments. But these economic contraction measures reflected a fall of internal aggregate demand in real terms. In other words, during 1989, the real GNP dropped 8.6% with respect to the previous year.

At the beginning of 1989, the level of inflation was registered at 30%. It was necessary to make a strong adjustment to the exchange rate. The new government eliminated the exchange rate controls and also progressively eliminated the price controls system, and subsidized numerous goods, most importantly gasoline. These deregulated government economic policies, while increasing prices, was part of the macroeconomic adjustment program that was considered necessary to achieve economic balance and to foster growth, productivity, and efficiency.

The incoming administration of Carlos Andrés Pérez had anticipated some dissatisfaction as a result of this 'shock therapy' treatment for Venezuela's ailing economy.

On February 27, 1989, the population of Caracas, which was already exasperated by the absence of even the most staple of items from markets and stores, coupled with the increased cost of gasoline, witnessed the refusal by bus and taxi drivers to accept "Student Passengers' Entitlement" cards for discount of half-fare prices. This refusal,

due to added operating expenses associated with increased gasoline costs, sparked a "social explosion" within the city. Within hours, the unrest spread to the nearby port of La Guaira, and on to smaller cities and towns miles away from Caracas

The rioting which began with burned cars and smashed shop windows, evolved into wholesale looting. By the end of February 1989, human casualties of the riot included two dead and dozens injured.

By mid-March, the Pérez administrations economic plan of deregulation had increased the economic plight of the Venezuelan population. Yet, the crisis may have been an unavoidable price to pay in the short-term to achieve the long-term benefit of deregulation.

The new exchange rate system created only one free exchange rate, determined by the supply and demand of the market and by the timing of the new exchange rate plan. The nominal parity of the free market was BS 39.6 for US \$1.

At the end of 1989, the nominal exchange rate average was placed at BS 43.58 for US \$1, and by the end of 1990 the exchange rate was BS 47.04 for US \$1.

The increased costs associated with the devaluation of the free exchange rate were translated into a reduction of internal aggregate demand. On the other hand, the devaluation gave the government a greater quantity of BS and, at the same time, oil income increased due to an increase in the price of oil.

The increase in the consumer price index from 81% in 1989 was caused by a set of factors, among which the central bank of Venezuela emphasizes the following (Toro, 1990, p. 158):

- Dismantlement of a plan that was forcing prices to remain artificially low through government subsidies and the application of a system to control the exchange rate.
- Increase the prices of an important number of goods and services using the price control system previously administered because of problems attributable to supply administration.
- Anticipated purchases of products, mainly nutritional, before expectations of lack of supply and increases in prices.

- Cost increases associated with the exchange unification measures and increase in the price of fuels, public tariffs and wages, as well as the subsidies reduction.

The decade of the eighties was a period of gradual semi-devaluation and multiple exchange rates. Basic macroeconomic problems (recession, inflation, unemployment, external imbalance) took proportions previously unknown in Venezuela (Hausmann, 1992, p. 3).

In 1990, the number of articles included in the price regulated basket was reduced, and goods and public service prices were increased. This measure was considered necessary in spite of the fact that it brought inflationary pressures out in the open.

The consumer price index, though still maintaining abnormal levels in relation to historical levels (Figure 5), had, however, experienced an important reduction with respect to the year 1989.

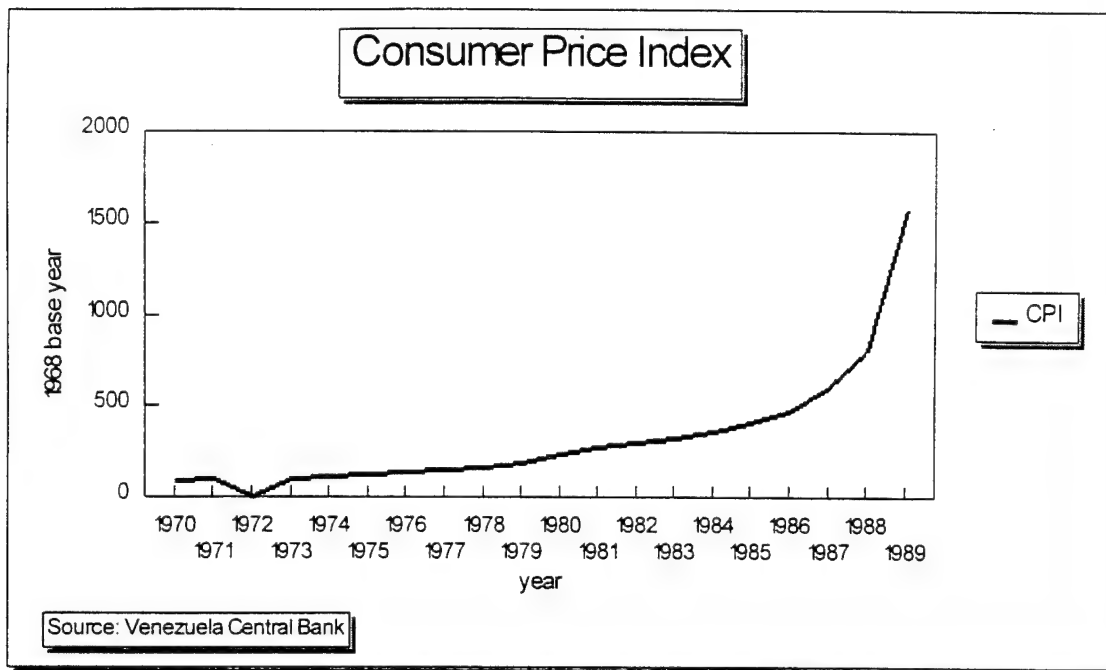


Figure 5. Consumer Price Index.

The economy assimilated a good part of the initial impact that was produced as a consequence of the elimination of the exchange rate controls and price controls.

The sudden jump recorded in the value of petroleum exports during the second half of the year 1990 as a result of the conflict in the Gulf, together with the expansion of public expenditure, made it possible to recover production activity and considerably reduce inflation. After an unprecedented increase in 1989 (81%), the annual inflation rate was cut to less than half (37%), which brought it back to the levels of 1987-1988.

The factors which helped to lower the rate of inflation included the ending of the period of application of measures to correct relative prices introduced during the previous year, and the slow-down in the rate of devaluation to less than 20% a year (United Nations, 1990, p. 449).

The oil income and the growth of the government expenditure brought an increase in the monetary bulk which was threatening to exercise pressure on the level of prices. In order to eliminate this effect, the central bank intervened in the monetary market as

well as in the exchange market with a contractive monetary policy, reducing the growth of the consumer prices index from 81% in 1989 to 36.6% in 1990.

In 1991, general increases of salaries and wages were decreed, causing an increase in the CPI. Again in 1992, a decree to increase the minimum wage was approved.

## **G. SUMMARY**

The corresponding inflationary pressure of the years 1990-1992, felt the influence of the Persian gulf war, which caused an increase in oil production as well as in the price of oil.

In Latin America, the average inflation during the eighties reached 80%. In many Latin American countries, inflation reached figures that surpassed four digits. It is certain that in Venezuela, inflation is negligible in comparison with other South American countries that experienced hyperinflation. However, it is very high when compared with previous periods, which had high stability, growth, and low levels of inflation (Toro, 1990, p. 111). Inflation was very high in 1980, and the consumer price index for the Caracas metropolitan area rose by 21.6 %, thus slightly exceeding the rise of 1989 and trebling the average rate of increase for the period 1975-1978.

In 1979, the rise in prices was due in large part to the policy of pricing applied in order to correct the sharp distortions in the relative price system. These distortions were generated during the period following the first large increase in the international price of oil in late 1973.

The reason why the inflation rate remained high in 1980 lay in a variety of cost and demand factors which contributed to the rise in prices (United Nation, 1979, p. 537). The two main causes relating to cost were the increase in wages and salaries and the increase in financial cost.

In 1981, the government stimulated economic activity. Prosperity produced by the oil, however, was of short duration. In 1982, a strong fall in the price of oil reduced government oil income. In 1983, the drop in oil price was much more acute, and income fell to below that provided by the sector in 1980.



The change of economic policies from a fiscal contractive policy to an expansive policy was not accompanied by an increase in the productive capacity of the economy, and it merely produced an increase in inflationary pressures.

Other factors also contributed to the increase in the level of prices, among them:

- The liberalization of price controls.
- The low productivity levels of the economy.
- The increase in salaries and wages imposed as of January 1980 was not accompanied by increases in the production levels nor the level of productivity.
- The high level of the interest in the financial markets, local as well as international, contributed to the contraction of the investments in Venezuela, with the consequent negative effect on the production levels.

It is clear that international inflation was one of the causes of the pronounced inflationary process affecting Venezuela. This occurred because of the inflation in most of the industrialized countries, and its consequent effect on the prices of their manufactured goods (United Nations, 1980, p. 41).

As a result of the major increases that took place in the international price of hydrocarbons during 1980, the rise in the unit value of imports was still greater in the petroleum exporting countries such as Venezuela, where this value increased by 27% in 1980 (United Nations, 1980, p. 41). The entire world was seriously hurt by the inflation that was unleashed; developed countries as well as the developing ones suffered equally. Simultaneously, both groups of nations were affected by a serious phenomenon that economists call stagflation due to the fact that recession and inflation occur at the same time.

In an econometrics study (Toro, 1990, p. 155) that took place between 1983 and 1990, it was determined that there are three variables that influence prices in Venezuela: government expenditure, non-oil real GNP, and worker and personal remunerations. This leads to the following conclusions:

- Each increase of 1% in the government expenditure, generates an increase of 0.37% in the consumer prices index.

- Each increase of 1% in the non-oil real GNP, generates a decrease of 0.95% in the consumer prices index.
- Each increase of 1% in the personal and worker remunerations, generates an increase of 0.79% in the consumer price index.

These results confirm that, in Venezuela, the government expenditure and the increases in the level of personal and worker remunerations, when they do not correspond to parallel increases in the volume of goods and services produced, are translated into greater than normal increases in the price level. On the other hand, an increase in the non-oil real GNP forces prices to decrease, since it reflects an expansion in the volume of the goods and services that are produced in the country.

Inflation is considered a phenomenon of economic character, but its impact exceeds the area of the economy; it also has social and political consequences. The consequences that are derived from an inflationary process can acquire characteristics that disturb the base upon which the economic activity of a nation is seated.

During the 1980s, the standard of living of the Venezuelan population fell significantly, in part as a result of the fall of the international prices of oil and of a set of postponement policies of macroeconomic adjustment that generated an acceleration of inflation and a real contraction of the job market. At the same time, the unavoidable fiscal adjustment had important effects on the capacity of the population to accumulate and maintain their human capital, with the foreseeable consequences in distributive terms.

The measurement of income is basic to the economic and social design policies, one of whose fundamental objectives in developing countries is to reduce the degree of distributive inequality. The income distribution figures fulfill an important function in helping to identify the impact of the fiscal policy, and in public management of different groups. Naturally, this permits the improvement of the process of assigning subsidies and permits the government to distribute the effect of the policies among the different groups in the society.

In 1994, a few months after having taken charge of the government for the second time, president Rafael Caldera (1994-1998) again imposed an exchange rate control.



### **III. IMPACT OF INFLATION IN VENEZUELA**

#### **A. INTRODUCTION**

Demand for workers depends on the firm's decisions in relationship to the workers' productivity and the cost of the employment to the firm. It can be established that a firm will contract more workers while the revenue of its marginal product is greater than the salary. On the other hand, if the wages surpass the revenue of the marginal product, the firm will reduce the number of workers (Toro, 1993, p. 99). In a more productive economy, remuneration of the work factors will be better. This occurs because the salary accrued by the workers will tend to be equaled by the productivity of the marginal revenue of the firm.

Nominal salary is the amount of money received per hour or per day. Real salary is the amount of goods and services that can be bought with the nominal salary. For that reason, the work demand does not depend on the nominal salary, but on the real salary (Toro, 1993, p. 100).

The wage increase during 1977 to 1989 consistently lagged behind the inflation in Venezuela (Figure 6).

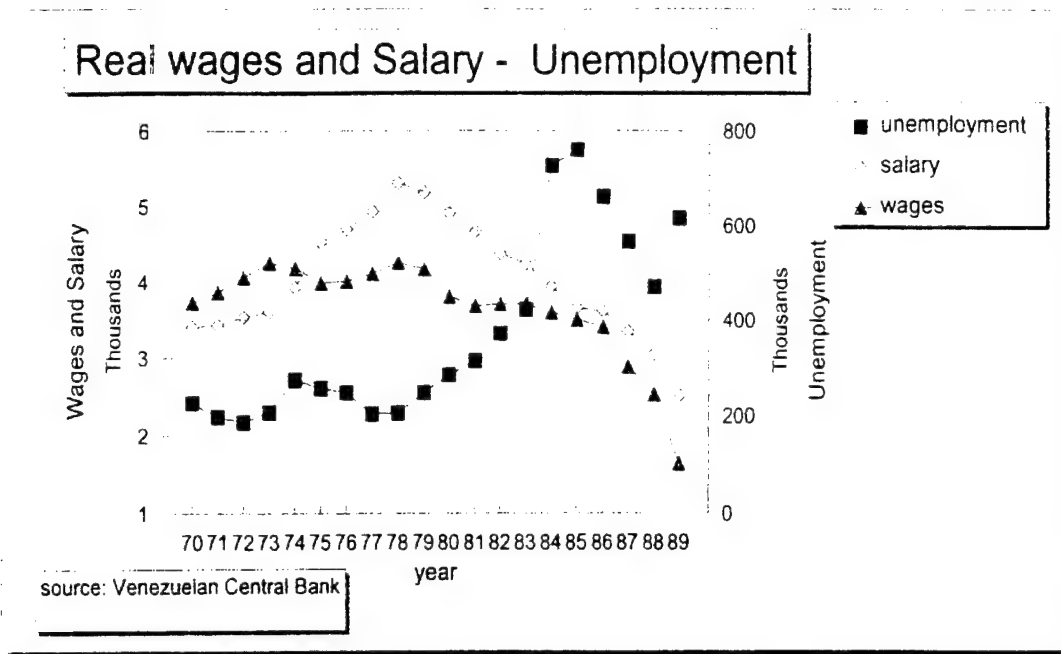
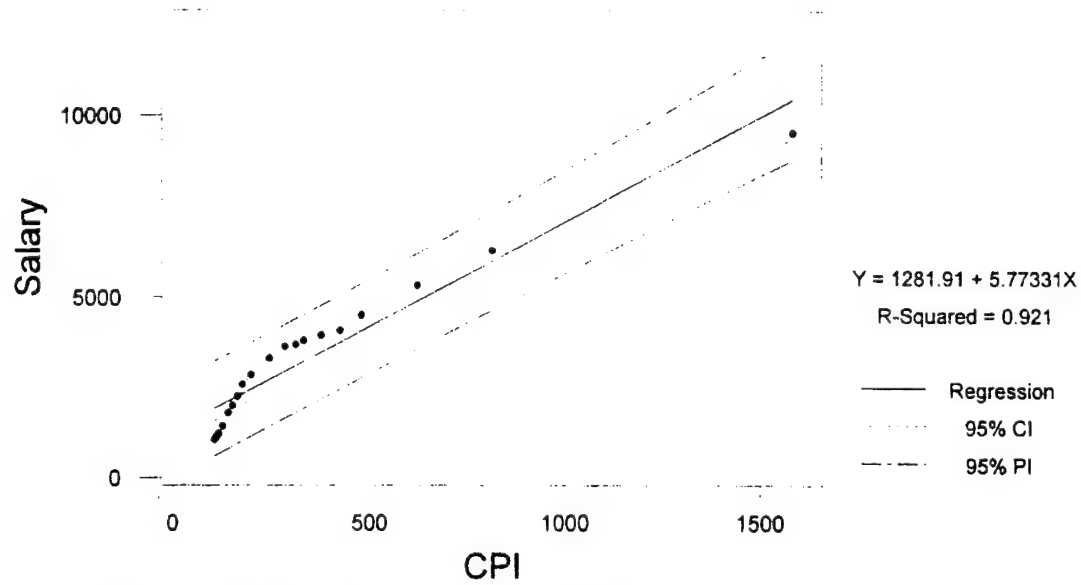


Figure 6. Real Wages and Salary/Unemployment.

To get an idea of the effect of inflation, a regression of the nominal wages and nominal salary against the consumer price index can be used, with the following result: each point in the increase of the consumer price index increases the nominal wages by 3.86 and nominal salary by 5.87, with high correlation factors (Figures 7 and 8).

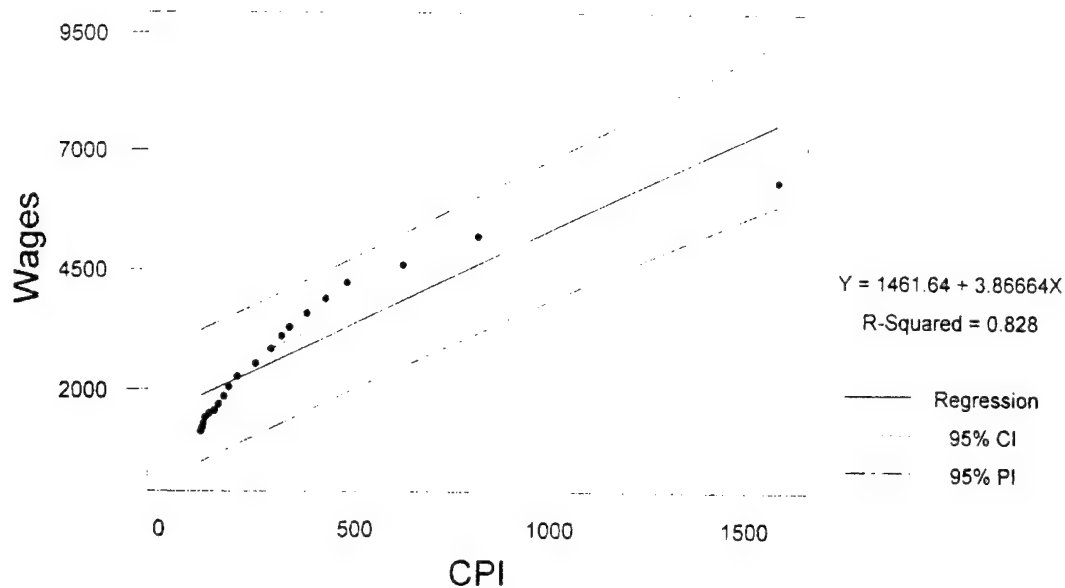
## Regression Plot



source: bases cuantitativas de la economia Venezolana

Figure 7. Regression Plot Salary/CPI.

## Regression Plot



source: bases cuantitativas de la economia Venezolana

Figure 8. Regression Plot Wages/CPI.

In these conditions, inflation has a very important influence on the determination of real salary. Normally, the nominal salary increases when inflation increases, but real salary decreases.

Real salary will be maintained only if inflation and demand for employment grow at the same pace. In fact, real wages have fallen constantly, and the demand for employment has not increased in the 1980s (Figure 9).

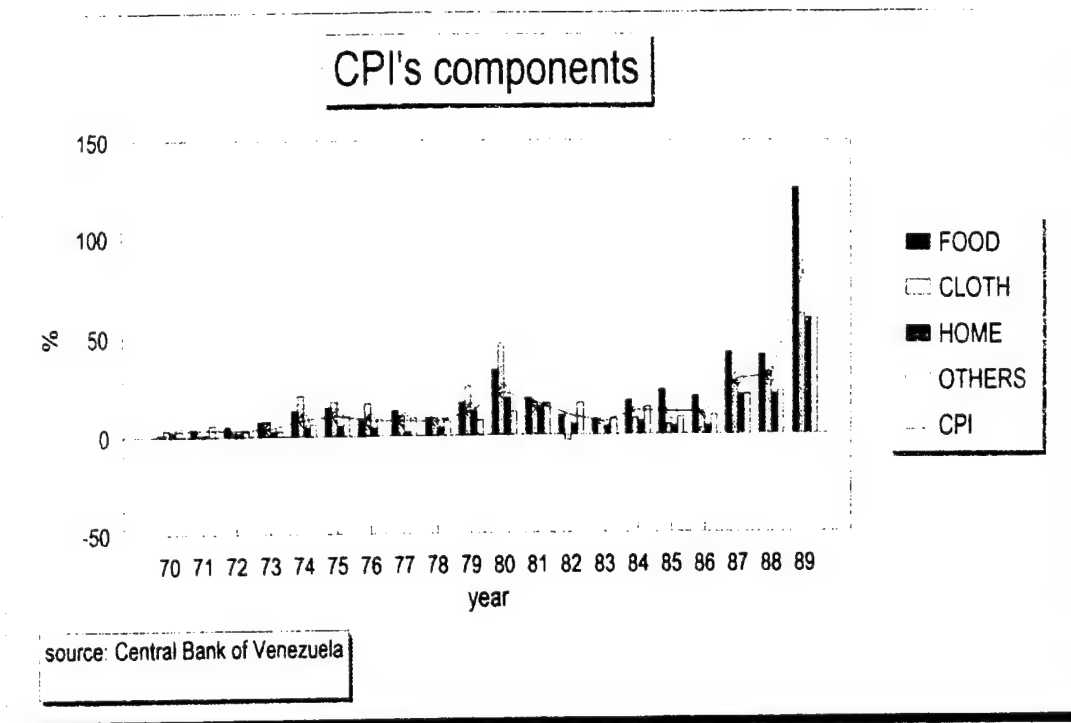


Figure 9. CPI's Components.

The Phillips curve is useful for analyzing short run movements of unemployment and inflation. It states that there is an inverse relationship between unemployment and the changes in money wages. Wages tend to rise when unemployment is low and *vice versa* (as seen in Figure 6). The reason is that workers press less strongly for wage increases when fewer alternative jobs are available, and in addition, firms resist wage demands more firmly when profits are low.

## B. INFLATION AND RELATIVE PRICE VARIABILITY

One of the established facts in the analysis of inflation is that increases in the speed of inflation tend to increase the variability of relative prices. In other words, under normal inflation, all prices tend to move at the same pace with respect to the price index.

On the other hand, in a process of high inflation, prices tend to move at a different rate.



In Venezuela, the price of food showed a larger variation with respect to the general consumer price index, growing when inflation increased. Each inflationary outbreak has increased the variability of the relative prices. The weighted variance of the changes in the components of the CPI has represented an approximate measure of the magnitude of that change in relative prices of the goods which compose the CPI market basket (Figure 10).

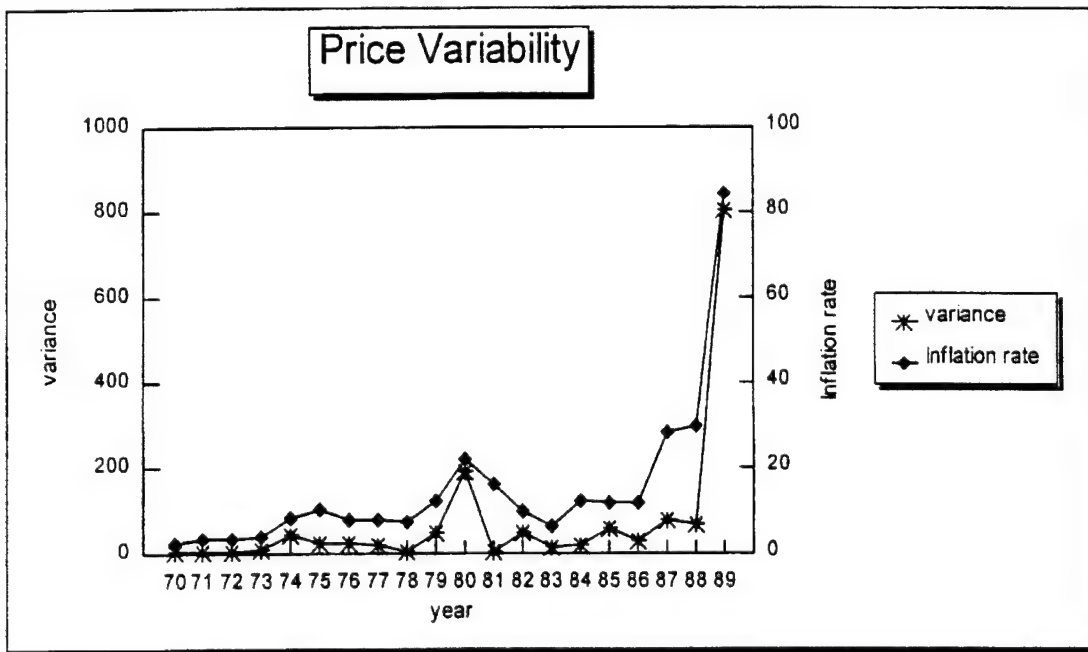


Figure 10. Price Variability.

### C. INCOME DISTRIBUTION

Within the total population, each social group consumes goods in different proportions according to its income level. If a distribution of the families by income strata is built, it can be observed that each one of those groups has a different consumption structure (Table I). The poorest 25% of families spend more than 40% of their total income on food, while the richest 25% spend less than half of that percentage.

Group	I	II	III	IV
Food	41.44%	30.98%	25.00%	16.36%
Clothing	14.17%	14.67%	10.37%	9.25%
Home	23.22%	28.73%	31.58%	37.62%
Other	21.17%	25.62%	33.05%	36.77%

Table I. Family Consumption By Social Group.<sup>2</sup>

As a consequence of these differences in the consumption by each social group, the effect of price increases for each one of them is very different. The Income per Capita has declined during the 1980s with greater economic and social consequences for the country (Figures 11 and 12).

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<sup>2</sup> Inflation Economy and Society

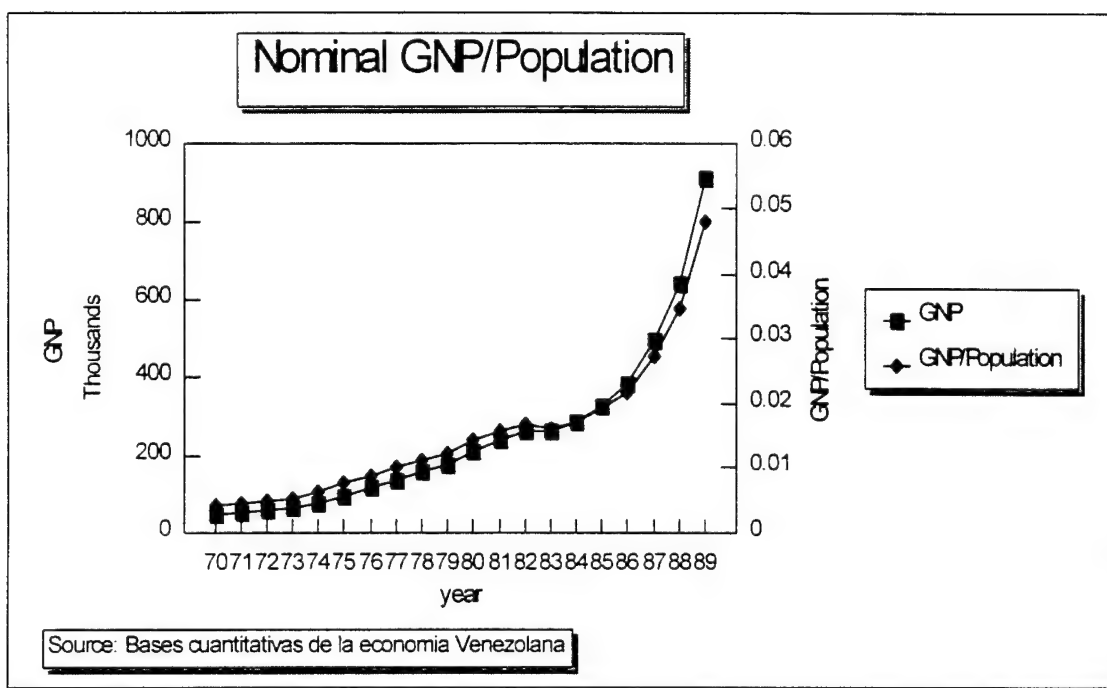


Figure 11. Nominal GNP/Population.

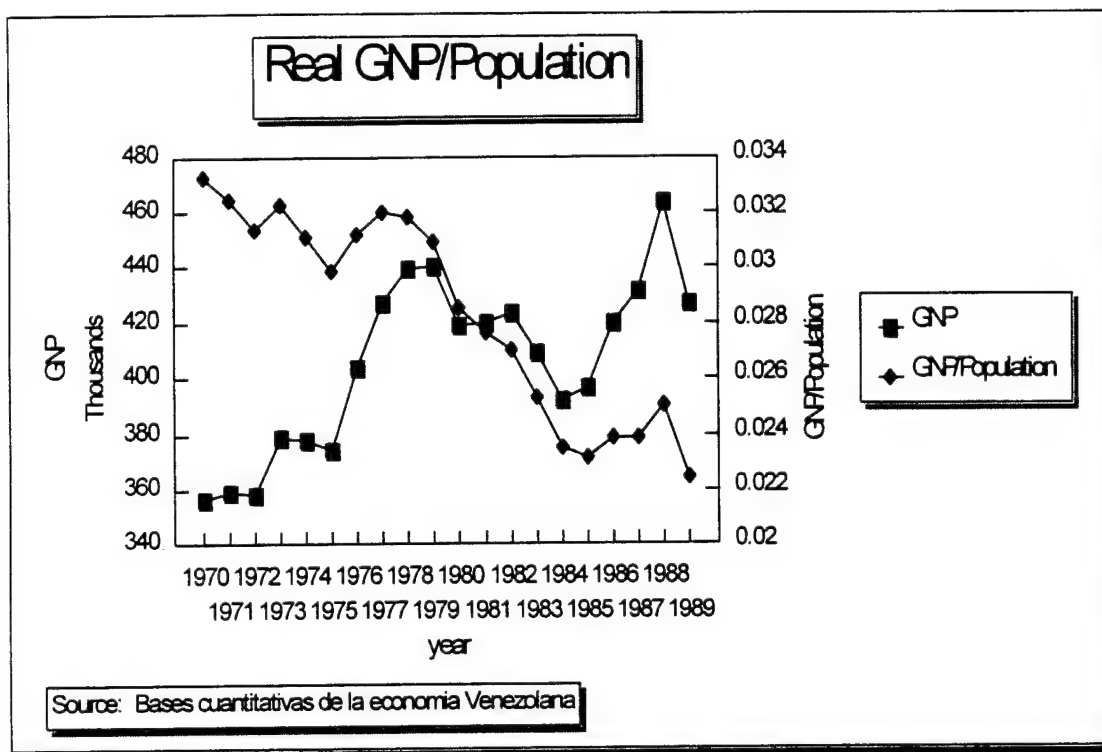


Figure 12. Real GNP/Population.



## **IV. FAMILY INCOME DISTRIBUTION**

### **A. INTRODUCTION**

There are two main reasons for being interested in the distribution of family incomes. The first is that the family is a social unit within which individual incomes are wholly or partially pooled. The second is that the family is the vehicle for passing on abilities, attitudes, and property rights from one generation to another. The family acts, therefore, both as a means of current redistribution of income and as a means of continuity and redistribution between generations.

The total income of a residential family depends on its size and composition as well as on the sources of income of its individual members.

Statistics on income distributions depend upon people's own reports of their income, as given to survey interviewers or the official agencies. Such reports are not always accurate. People are sometimes confused or forgetful. In other cases, they deliberately underreport income in order to hide illegal sources or to avoid taxes. Underreporting may conceal the full extent of inequality since self-employed individuals with relative high incomes, such as doctors and small businessmen, do not have wages automatically reported to the government and fail to report substantial amounts of earnings. On the other hand, some very low-income people with odd jobs also hide income in order to avoid taxes and stay below the income cutoff points of government welfare programs.

In addition to the problem of defining and measuring income, assessments of inequality are complicated by the fact that income receiving units differ; there are families of different sizes and unrelated individuals living alone or together.

If all 'households' or 'consumptions units' are lumped together, measured inequality does not reflect the actual experience of individuals. A family of four is not twice as well off as a family of two (or four times as well off as a single individual) just because it has twice (or four times) the income. Changes in income during the life cycle,

regional differences in prices and the savings of families can also modify the estimation of real inequalities of income.

One way which produces less measured inequality is to omit unrelated individuals. It is better yet to calculate on a household per capita basis so the whole population can be considered and so that large families don't look too rich compared with small families. It is best to base calculations on equivalence units, which take account of economies of scale and joint consumption; a given amount of per capita income usually goes farther in a large group than a small.

It is clear that the most desirable situation would be to have income distributions available for a country by economically active persons, by households and by individuals for the same year. That would be the only way to measure the real inequalities of any country on real inequalities of income and standard of living.

One concise way of characterizing the degree of inequality in an income distribution is by means of the Gini coefficient, which can vary from zero (complete equality) to one (total concentration of all income in the hands of one individual).

In order to compute a Gini coefficient, people are first arrayed along a line in order of increasing income, and a Lorenz curve is drawn indicating the cumulative percentage of income received by each cumulative percentage of the lowest-income earners (Page, 1983, p. 10). (The Lorenz curve for a completely equal distribution would be a straight diagonal line.) The Gini coefficient then measures how far a Lorenz curve deviates from the diagonal; it is calculated as the area between the curve and the diagonal, divided by the total area under the diagonal.

Another complication is that many reported income figures include cash transfers from government: welfare payments, social security payments, and the like. Government also influences how much money people get and what prices they have to pay for goods and services through a multitude of laws and regulations that play a part in determining the distribution of 'private' money income. They also affect non-monetary income, from such public goods as safety and air quality. by altering the market prices of other goods

and services, they affect what people can buy with their money and thereby change the distribution of real net incomes.

## B. FAMILY INCOME DISTRIBUTION IN VENEZUELA

The family income distribution in Venezuela in nominal terms has not had important variations during the 1980s, as can be seen in Figure 13. When the real GNP per capita increases, the Gini coefficient decreases, indicating that there is a better family income distribution (Figure 14). The same relationship can be found between real wages and salaries, and the Gini coefficient because when wages and salaries have decreased the Gini coefficient shows a more unequal family income distribution (Figure 15).

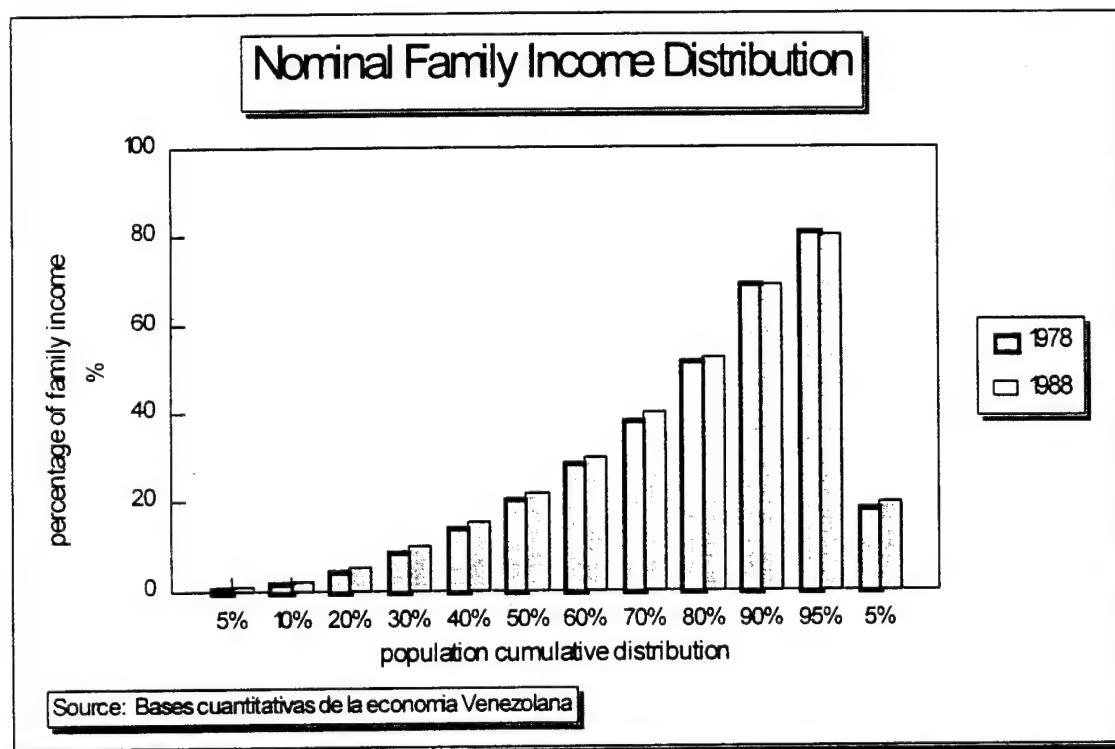


Figure 13. Nominal Family Income Distribution.



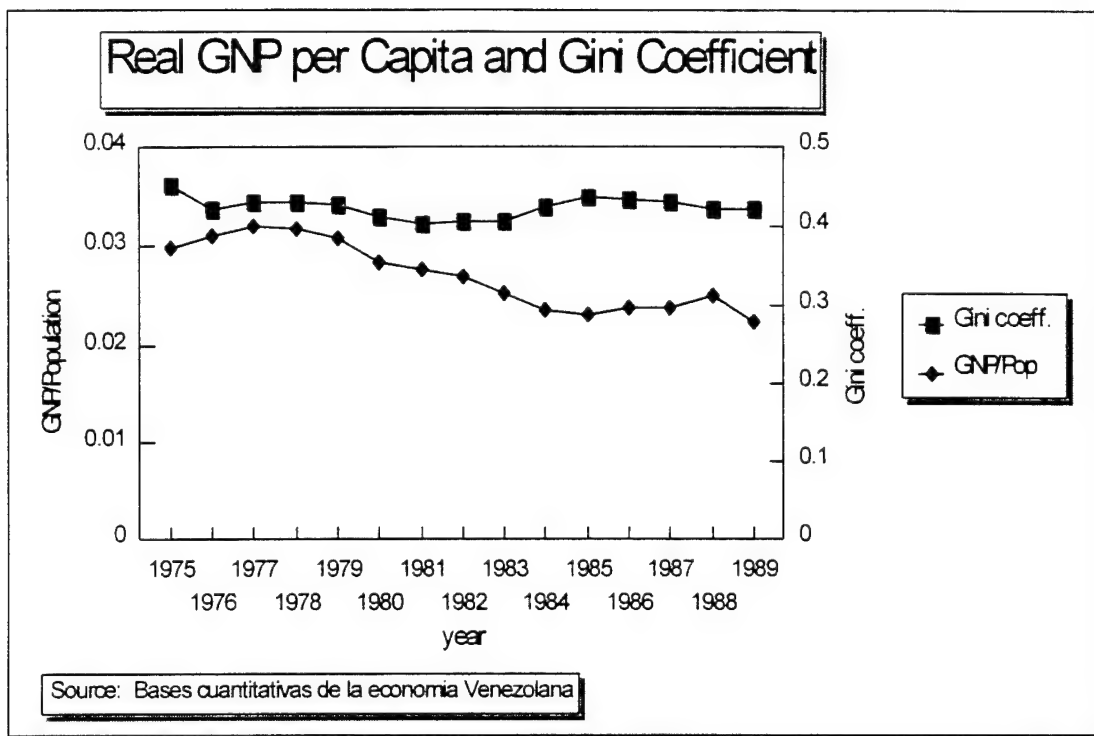


Figure 14. Real GNP per Captia and Gini Coefficient.

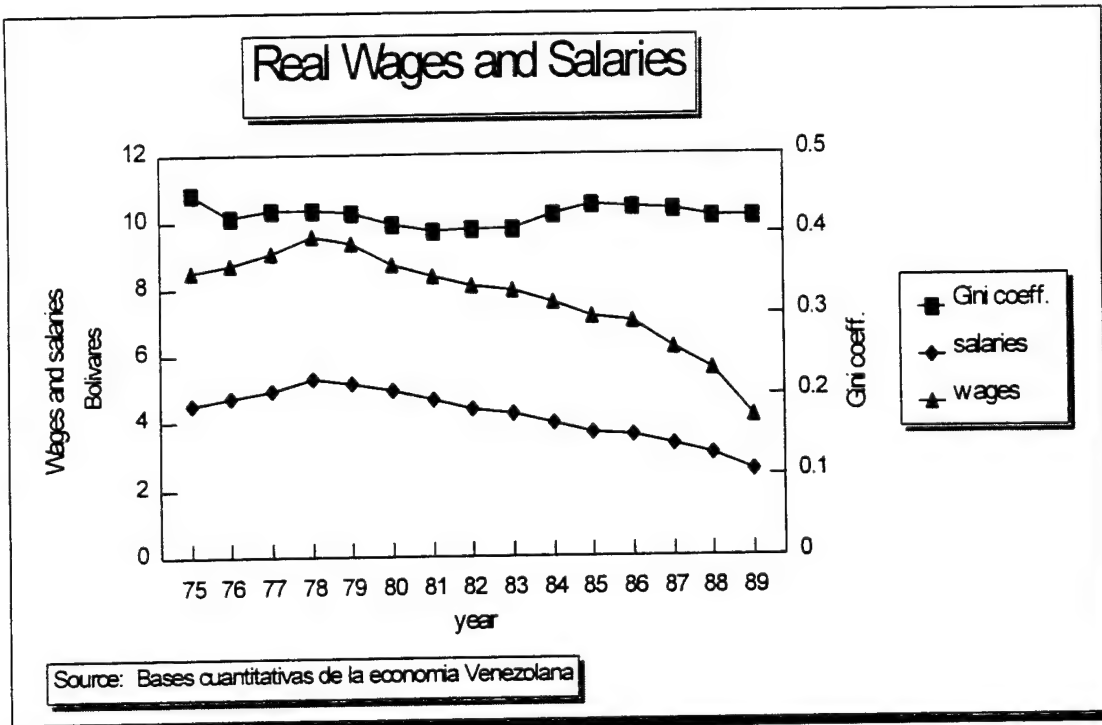


Figure 15. Real Wages and Salaries.

If inflation is taken into account, family income distribution improved between 1977 and 1981 when there was high inflation, because during this period wages and salaries were increased frequently by government decree.

In 1989, the government began to deregulate the economy, resulting in a large reduction of real family income due to repressed inflation that rose 82% in the first year then sharply falling to 36.5% in 1990, and further falling to 31% in 1991.

During the period of government intervention and regulation, it appeared as though family income had not changed. However, Venezuelans were unable to purchase goods and services as they were in shortage. Conversely, during the deregulation period, beginning in 1989, family income showed a considerable reduction, but goods and services were plentiful.

As a result, though reported family income dropped during deregulation, purchasing power of a given bolivar of family income was greater because goods and services were available at market prices. Therefore, the apparent decline in real family income was certainly much smaller than it appears to be.

During the period of 1981-1988, unequal family income distribution increased along with the fall of the real wages and salaries (Figure 16).

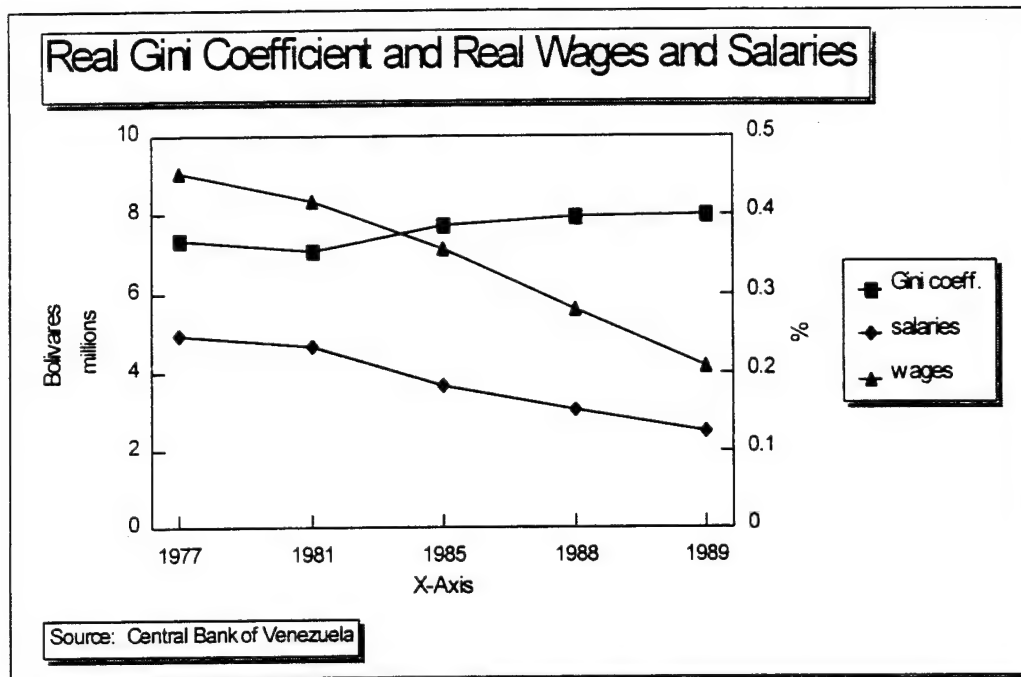


Figure 16. Real Gini Coefficient and Real Wages and Salaries.

The average family money income has fallen, where the first decile falls at 6.2% average inter annual and the last decile fell at an average of 3.6%. In other words, while all are poorer in 1989 than in 1977, the distance among each family group has increased significantly (Table II, Figure 17).

A reduction of 10% in the family income of all the population does not have the same effect on all families. A reduction of 10% of family money income on families with greater money income probably means a reduction in the purchase of luxury articles, while the same percentage of reduction in the family group with less money could probably represent a reduction in food consumption. The analysis of the family money income distribution shows that the evolution of the Venezuelan economy in the decade of the eighties made all Venezuelans relatively poorer.

Percentile	1977	1981	1985	1988	1989
1	4408	4440	3243	2945	2036
2	7340	7535	5674	5074	3798
3	8605	9603	7215	6329	4763
4	11260	12211	8853	7188	6182
5	13063	12997	11321	9684	8123
6	14469	16786	12079	12647	8103
7	20061	19494	15595	12647	10755
8	21186	23196	21575	16886	13709
9	27850	29220	22017	20469	16474
10	50338	48671	44784	41486	32181
Table II. Real Family Income.					

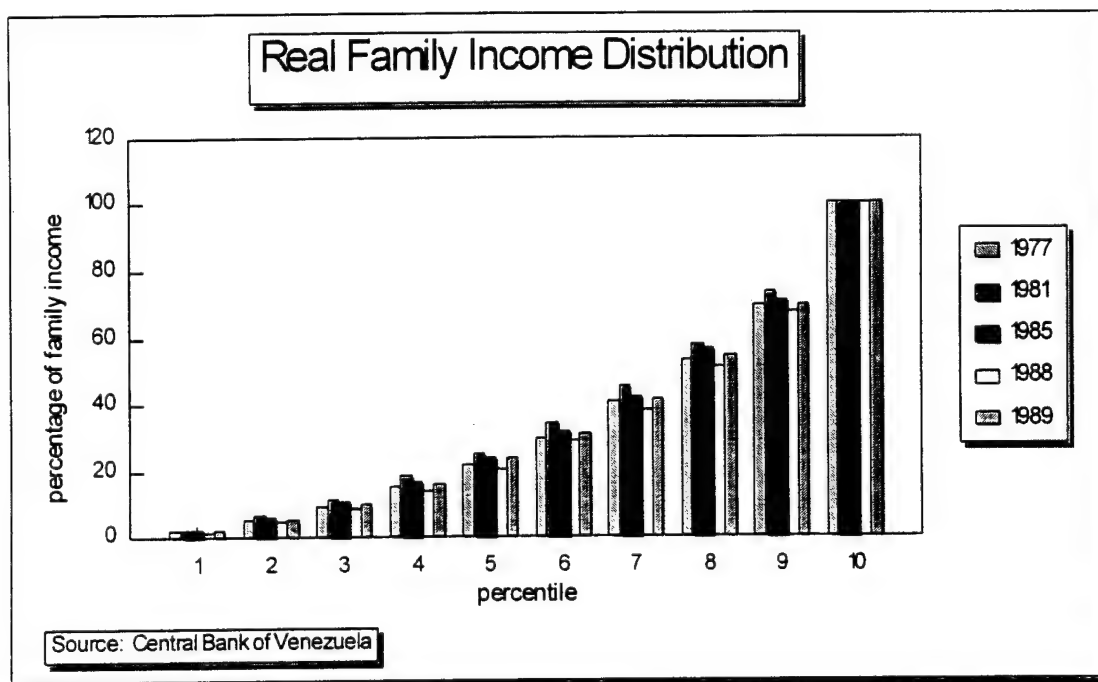


Figure 17. Real Family Income Distribution.

It is clear that the costs of inflation have been disproportionately distributed, with a part falling on the sectors of the population with less money income.



## V. CONCLUSIONS AND RECOMMENDATIONS

### A. CONCLUSIONS

The following are the conclusions of the analysis of inflation's effect on family income distribution in Venezuela during the 1980s.

Family income distribution did not change significantly during the 1980s due to government regulation policies which affected income distribution.

Government also influenced how much money people got and what prices they had to pay for goods and services through a multitude of laws and regulations, especially using price controls, exchange rate controls, and increases in salaries and wages. By altering the market prices of other goods and services, the government affected what people could buy with their money, thereby changing the distribution of real net income.

Although they have sometimes been effective for a short time, in the long run, controls have either blown up or become ineffective because people evaded them.

In theory, regulation can be viewed as simply another tool for providing public goods. This argument is often compelling. *Laissez faire*, or unhampered free enterprise, would produce some inefficient outcomes. Yet the results of regulation in some cases have turned out to benefit the regulated rather than the general public and have actually created inefficiencies.

Inflation, unemployment, economic growth, and such aggregate economic phenomena had substantial effects on the distribution of income. They were affected by many policy choices involving overall levels of government spending and taxation, the size of surpluses or deficits, modes of financing debt, the structure of the tax system, the amount of money printed, and the level of interest rates. Taken all together, these choices constituted macroeconomic policy.

If inflation were fully anticipated accurately, it would not hurt anyone. With such inflation, prices would rise, but wages would also rise at the same rate and *vice versa*; everyone would have to pay more for goods and services, but everyone would have more money to spend and would be no worse off. Wage raises or cuts may be added to or



subtracted automatically which counterbalances inflation; savers get a nominal interest rate plus the amount needed to offset the decline in value of their capital. Prices, as usual, move up or down relative to each other, but all such rises and falls are tacked onto a basic inflation rate.

Inflation in Venezuela however, affected each one of the social groups in a different measure and in a different form. A good deal of the harm resulted from large relative (rather than general) price increases, especially rises in the cost of food despite government effort. This is partly because a significant portion of food items are imported from other countries and the currency devaluation was most significant in food prices. The damage fell especially heavily on the poor and in groups of smaller family money income, who spend a high proportion of their income on food.

Tight macroeconomic policies in Venezuela were used to attack inflation. Although the policies were effective in slowing inflation, they compounded adverse effects on employment.

Entrepreneurs and professionals were better adapted to inflation, because they had the possibility of protection through strategic investments in goods, foreign currencies and financial titles, administering prices, inventories and wages.

People who make their living from wages managed less well than entrepreneurs and professionals. Their wage level, in the absence of effective wage-indexing, did not keep up with the pace of inflation. They often resorted to buying all they can to protect their eroding income level.

There is a high political cost to stop inflation. If a trend exists toward the increase or maintenance of an inflationary economy, its explanation resides in the forces which formulate the economic policies of the country. Assuming the orthodox position that the immediate cause of inflation is excessive growth of the money supply, and since the monetary policy and fiscal controls depend on the government, it can be concluded that inflation is a product of political decisions. This is true in Venezuela, since the state has a monopoly on decisions to control inflation based on the creation of money, the approval of public credit, and the guarantee of the sovereign debt.

The president is above pressure groups and he serves the general interest of the population. It is a fundamental condition that presidents believe in the need for stopping inflationary expenses. But to execute policies against inflation is more difficult than to carry on inflationary policies, because they must necessarily face the issue of who will pay or who will decrease their consumption.

## **B. RECOMMENDATIONS**

In the decade of the fifties and sixties in Venezuela, a tradition existed of maintaining balanced budgets and of not approving a budgetary deficit without the necessary economic resources available for controlling the fiscal excess. But due to the increase in the economic resources originating from oil, Venezuelans felt for the first time free of that resource's constraints. Helped by some external factors, such as bankers' willingness to finance excess consumption, they ended up falling into an expansion of government expenditure which with time created a deep imbalance in the economy. When the price of oil was reduced drastically beyond the initial planning expectations, the effects of the external debt, inflation and the impossibility of complying with development plans appeared.

For that reason, it is necessary to go back to the original sources of social control when imposing procedures to assure that government expenditures will be efficient and have adequate financing.

The definitive solution to the problem depends necessarily on the restriction of demand in the first stage; the subsequent growth will depend only on the capacity for expanding the productive capacity of the country.

A market strategy has been urged by many economists to attempt to moderate inflation. It emphasizes strengthening market forces by deregulation of regulated industries, removing market impediments to competition by perverse antitrust laws and in retail price maintenance, repealing government laws that inhibit competition such as foreign trade quotas and minimum wage laws, banning labor union monopolies, and above all encouraging international competition.

Those who favor a more egalitarian distribution of income and want to do something to reduce inequality would do well to consider the political causes of past failures to accomplish redistribution, which have important implications for future action.

The central point is that, over the long-term, egalitarian results will require more market strategy than has previously been practiced in Venezuela.

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